COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

29 June 2018

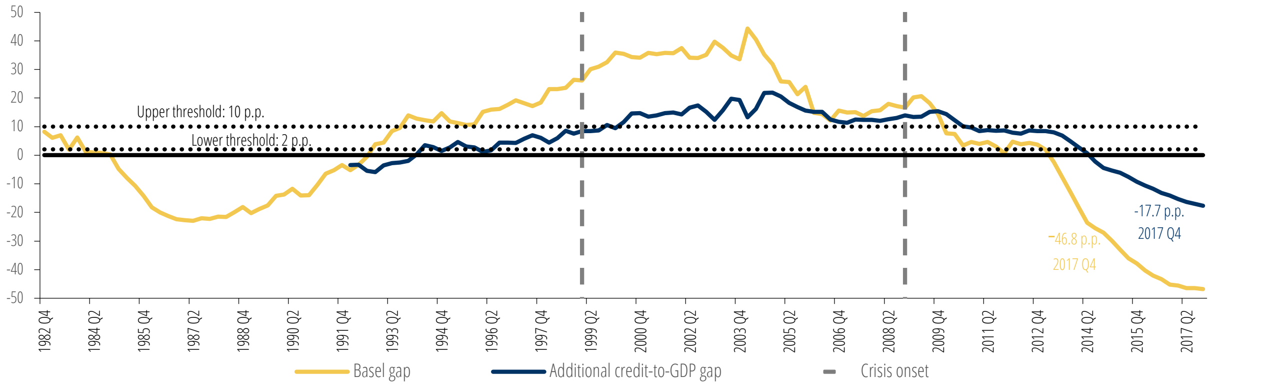
Pursuant to a decision of the Board of Directors of 27 June 2018, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 July 2018.

This decision is based on the overall assessment of a set of financial and macroeconomic indicators.[1]

Credit cycle position is negative

At the aggregate level, the credit cycle position in Portugal is still negative. In the fourth quarter of 2017, the Basel gap was -46.8 percentage points (p.p.) and the additional credit-to-GDP gap was -17.7 p.p. (Chart 1). The credit-to-GDP ratio has been declining since 2013 on the back of declining credit and increasing nominal output. This evolution in tandem with the inertia underlying the trend estimate explains the steady negative trajectory of both gaps, which is unlikely to reverse in the 2018-2020 period for the reasons underscored in the previous assessment report. Nevertheless, the year-on-year change of the Basel gap is approaching zero, meaning that the negative trajectory is decelerating (Chart 2).

Chart 1 Basel gap and additional credit-to-GDP gap[2] | In percentage points



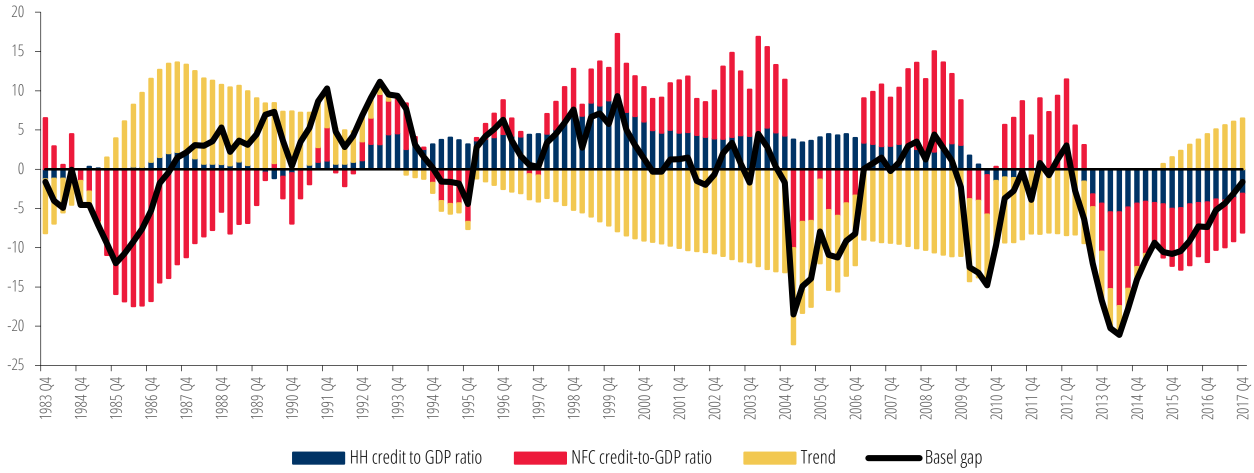
Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation is dated 2017 Q4. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

[1] The assessment is based on data available up to 27 April 2018. Any differences in figures from previous assessments are due to revisions in underlying data. The set of indicators covers the six categories set out in Recommendation ESRB/2014/1.

[2] The credit-to-GDP gap is calculated as the percentage point difference between the observed credit-to-GDP ratio and its long-term trend, where the trend is estimated employing a one sided HP filter with a smoothing parameter set to 400,000. The additional credit-to-GDP gap is computed as the percentage point difference between the observed credit-to-GDP ratio augmented with ARIMA(p,1,0) forecasts, using a maximum forecast horizon of 28 quarters, and its long-term trend, where the trend is estimated employing a one-sided *Hodrick–Prescott* filter with a smoothing parameter set to 400,000. Until the first quarter of 2015, the optimal lag order (p) of the forecasting model is recursively determined. From the second quarter of 2015 onwards, p is set to three quarters, which is the optimal lag length when data until the first quarter of 2015 is used. In case the gap exceeds 2 p.p., the benchmark buffer rate will increase linearly from 0% to the upper threshold of 2.5% of the total risk exposure amount, which is associated with a gap of 10 p.p.. See Recommendation ESRB/2014/1 Annex Part II available at http://www.esrb.europa.eu/pub/pdf/recommendations/2014/140630_ESRB_Recommendation.en.pdf?03a7c5c908620b34673b6f290b54c13d. Basel Committee on Banking Supervision thresholds of 2 p.p. and 10 p.p. were determined using the Basel gap. Nevertheless, they are used as an approximation to map the additional credit-to-GDP gap into a benchmark buffer rate.

Behind this evolution is the positive contribution of the trend, which is starting to accommodate the prolonged decline in credit during the crisis, and the less negative contribution of the credit to individual sectors. As both gaps remain negative, the implied benchmark buffer rate is 0% of the total risk exposure amount.

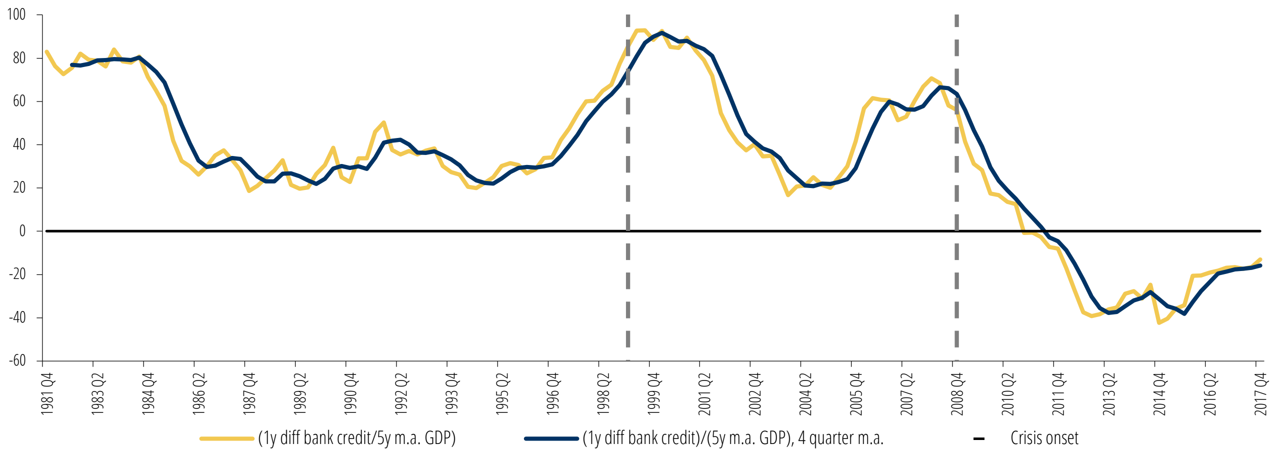
Chart 2 Annual change in Basel gap and contributions of its components | In percentage points



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation is dated 2017 Q4. p.p. stands for percentage points, HH stands for households and NFC stands for non-financial corporations. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The ratio between the annual change in bank credit to the private non-financial sector and the five year moving average of nominal GDP kept the upward trajectory initiated in 2015 (Chart 3). This evolution corresponds to the net effect of the gradual increase in output and the deceleration in credit contraction.

Chart 3 Ratio between the one year difference in bank credit and the five year moving average of GDP[3] | In per cent



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation is dated 2017 Q4. m.a stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

As of end-2017, the stock of total credit to the private non-financial sector was still contracting at a pace of 1.9%, year-on-year in real terms, due to a reduction in outstanding credit of both non-financial corporations and households. The net flow of credit to non-financial corporations declined, due to a reduction in both loans granted by the resident

[3] Ratio between the one year absolute difference of bank credit and the five year moving average of GDP, as proposed in Kalatie et al (2015), "Indicators used in setting the countercyclical capital buffer", Bank of Finland Research, Discussion Papers, No.8/2015. Bank credit extended by resident monetary financial institutions as available in Monetary and Financial Statistics published by Banco de Portugal. Nominal GDP is obtained from National Accounts, ESA2010, base 2011, published by Statistics Portugal.

banking sector and issued debt securities, while financing from the non-resident sector remained positive in the fourth quarter of 2017. In contrast, the net flow of credit to households increased in the fourth quarter of 2017, mainly due to a positive contribution from resident financial institutions that surpassed the negative contribution of loan redemptions and loans maturing.

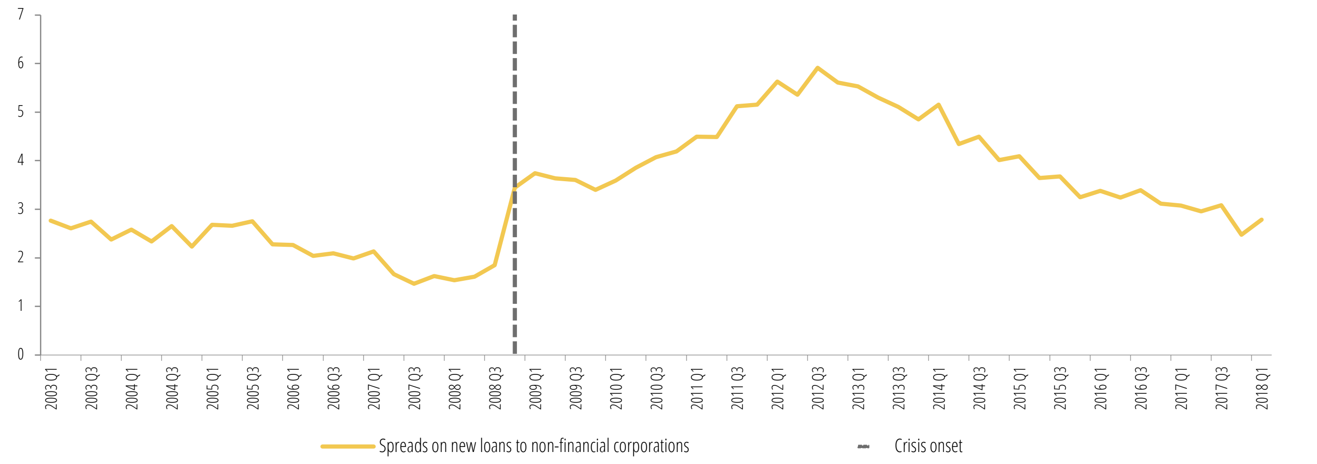
The stock of real bank credit to the private non-financial sector continued to contract in the first quarter of 2018 (-2.8%, year-on-year), albeit at a more moderate pace than in the previous quarter (-4.3%, year-on-year). The situation at the sector level is aligned with the aggregate, as real bank credit granted to households and to non-financial corporations contracted year-on-year 1.4% and 4.7%, respectively, in the first quarter of 2018. The volume of repayments, especially for mortgage loans, and the decline in the new loan production, across all segments, explain the contraction of the overall stock in the first three months of 2018, when compared with the same period in 2017. The stock of real bank credit for consumption is the only segment that has been increasing since the second quarter of 2016, presenting a year-on-year growth rate of 11.5% in the first quarter of 2018. However, it accounts only for 7.1% of the total bank credit to the private non-financial sector.

Overall, the set of indicators covering credit cycle developments displays no warning signs of emerging cyclical systemic risk.

New loans' spreads remain broadly stable

Spreads on new lending granted to the private non-financial sector have remained broadly stable in the first quarter of 2018, when compared with the previous quarter. In the case of non-financial corporations, new lending spreads up to one year reached 2.8 p.p. in the first quarter of 2018, picking up 0.3 p.p. when compared with the previous quarter (Chart 4). According to the information provided by the majority of the participating Portuguese credit institutions in the *Bank Lending Survey* of April 2018, the credit standards applied on loans to non-financial corporations should remain stable in the near future.

Chart 4 Spreads on new loans to non-financial corporations[4] | In percentage points



Sources: Banco de Portugal, Thomson Reuters and Banco de Portugal calculations.
Notes: The last observation is dated 2018 Q1. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database

Concerning households, spreads related to new loans for consumption and other purposes increased 0.4 p.p. to 6.7 p.p. in the first quarter of 2018 whereas those related to new loans for house purchase decreased 0.1 p.p. to 1.7 p.p. in the same period. Considering the information provided in the *Bank Lending Survey* of April 2018, the majority of the participating Portuguese credit institutions do not anticipate changes in credit standards applied on loans to households.

The average interest rate of new lending to non-financial corporations, increased from 2.2% in December 2017 to 2.5% in March 2018, whereas the average interest rate of new lending to households reached 3.4% in March 2018, rising 0.1 p.p. in comparison with the level observed in December 2017.

[4] Average of spreads weighted by the corresponding outstanding loan amounts at the end of the quarter. Spread is calculated against the three month Euribor rate as available in *Thomson Reuters*. Only interest rates on new loans granted by other monetary financial institutions to residents with initial rate fixation up to one year are considered. Interest rates on new loans as available in Monetary and Financial Statistics published by Banco de Portugal.

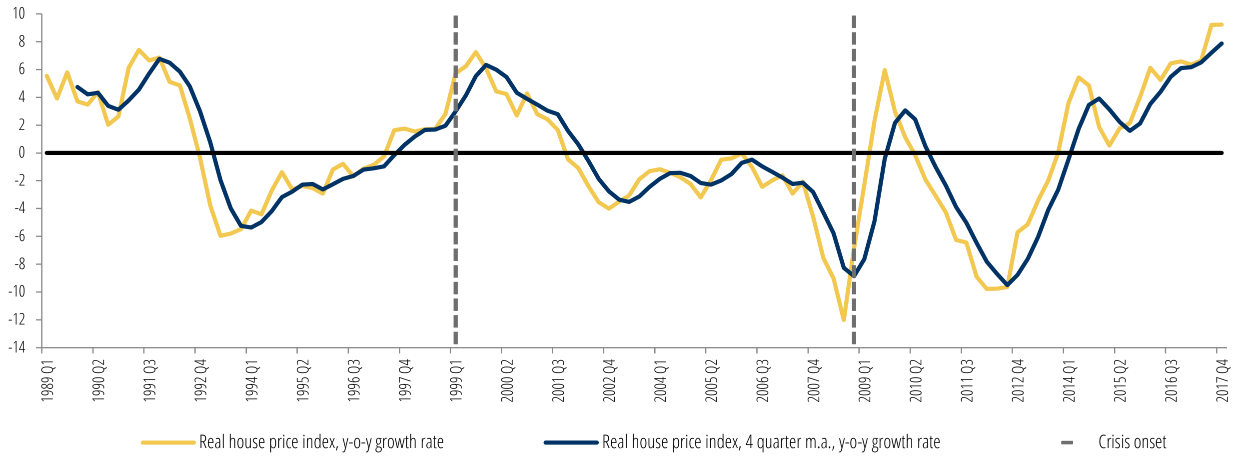
The evolution of spreads so far, whose levels are above those observed before the crisis, does not point to a significant relaxation of the underwriting standards by banks. Nevertheless, Banco de Portugal will monitor their evolution, in particular, the credit standards applied to households loans in the context of the recent macroprudential measure adopted by Banco de Portugal in the form of a Recommendation that will enter into force as of 1 July 2018.[5]

The debt-service-to-income ratio[6] of the private non-financial sector continued its downward path reaching 16.6% in the third quarter of 2017, representing a year-on-year decrease of 0.5 p.p.. This reduction is explained by an increase in income of the private non-financial sector, associated to the positive phase of the business cycle, coupled with the decline in the cost of debt servicing, as a result of the current low levels of interest rates. Despite the foreseeable increase of market interest rates, stemming from the gradual phasing out of the current accommodative monetary policy, we do not expect a material increase in this ratio in the short-run.

Residential house prices continued buoyant

In the fourth quarter of 2017, real house prices continued in an upward trajectory in line with the evolution described in previous assessment reports, in the aftermath of the adjustment that took place during the crisis (Chart 5). Nevertheless, and in contrast with previous quarters, the year-on-year growth rate for the fourth quarter of 2017 maintained the level observed in the third quarter of 2017 (9.2%).

Chart 5 Year-on-year growth rate of house prices, in real terms[7] | In percentage



Sources: Organization for Economic Co-operation and Development.
Notes: The last observation is dated 2017 Q4. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

This continued growth has been mostly driven by the rebound of households´disposable income, favorable funding conditions, foreign investment in the residential real estate market and the dynamics in tourism, particularly in what relates to Local Accommodation activity, which has been seen as a profitable alternative investment. In addition, in some residential areas, the pressure coming from the demand side has not been accompanied by an increase in the supply, thus contributing to the increase in prices. Despite the still low levels, when compared with the pre-crisis period, the number of construction-related licenses and completed buildings have been increasing, which could signal an upturn in housing supply and, consequently, have a potential effect in curbing house prices growth.

Finally, house prices are now slightly above their economic fundamentals, according to the ECB average valuation measure for the fourth quarter of 2017. However, it is worthwhile to mention that house prices do not seem to be underpinned by credit granted by resident financial institutions and the investment in residential property by non-residents has been gaining relevance.[8] Nonetheless, Banco de Portugal will continue to closely monitor further developments in this market.

[5] More information on the adopted macroprudential measure available at https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.

[6] Debt-service-to-income ratio estimates published by the Bank for International Settlements for the private non-financial sector, which uses gross disposable income as a proxy for income. Available at http://www.bis.org/statistics/dsr.htm.

[7] Real house price index (2010=100) published by the Organization for Economic Co-operation and Development. The house price index is adjusted for inflation using the private consumption deflator (2010=100) taken from the National Accounts (ESA2010, base 2011) published by Statistics Portugal.

[8] For more details see Box 5 "House price developments in Portugal and implications for financial stability" in December 2017 Financial Stability Report.

Additional indicators do not signal the build-up of cyclical systemic risk

The loan-to-deposits ratio decreased to 92.6% in the fourth quarter of 2017, reaching a new minimum since the fourth quarter of 2000. The reduction of 1.3 p.p., from the previous quarter, stems from the combined effect of loans´ reduction and deposits´ increase.

In the last quarter of 2017, the Portuguese economy recorded a current account surplus of 1% of the GDP. According to the Projections for the Portuguese economy for the period 2017-2020, the domestic economy will continue to benefit from a favourable external environment, due to the expected economic expansion cycle of Portugal´s main trading partners. Therefore, the current account is projected to remain positive over the projection horizon.

General assessment

The large majority of the indicators chosen to assess the emergence of cyclical systemic risk in Portugal justifies keeping the countercyclical buffer rate at 0% of total risk exposure amounts over the third quarter of 2018, despite the developments in the residential real estate market that demand close monitoring.